PCM

PEAK CAPITAL MANAGEMENT

Brace for Impact

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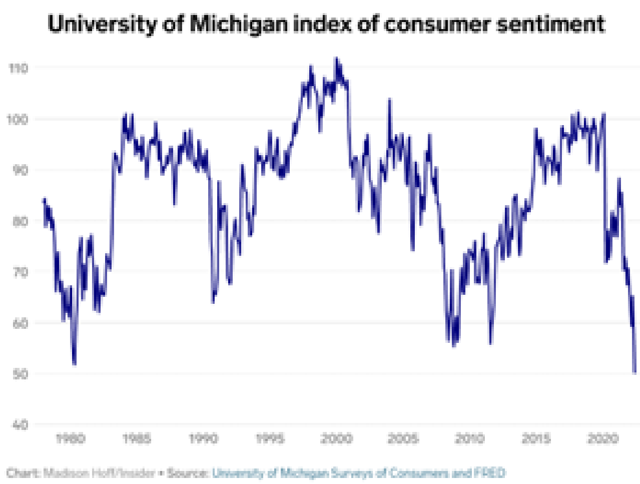
As the market comes to grips with Fed Chair Powell's policy of "hike until it breaks", it seems increasingly likely that we are going to experience a recession sooner rather than later. Articles are written about what the Fed needs to do to engineer a soft landing but the possibility of that as an outcome feels increasingly remote.

Fed Chairs have historically enjoyed a bully pulpit that allows them to use speeches on "anticipated" policy moves to achieve goals, often without having to implement the policy. Sadly, economic phenomena like inflation are immune to being influenced by a Fed's bully pulpit. Even after multiple rate hikes, including a ¾ point increase at the June meeting with promises of more hikes to come, inflation remains stubbornly high. May PPI (Producer Price Index) shocked with a month over month increase of 0.8%, double the increase just a month earlier. Clearly inflation is not yet being impacted by articulations of anticipated Fed policy, suggesting rates have a long way to go before inflation is near the Fed's target.

Historically, the Fed has managed interest rate policy so that when a recession occurs, they have the ability to cut rates and stimulate borrowing to grow economic activity. We are now faced with the reality that the Fed may not have the ability to "rescue" the economy, or the markets, sending us into unchartered waters.



The S&P 500 was down 24% as of late June making it the fourth worst non-recession correction since WWII. The median recession-driven correction over the same period would take the S&P to 3650, about the level it traded in mid-June. The 10% rally off the June low suggests the markets have not entirely come to grips with what we anticipate is coming. From my perspective, we are still in the early innings of the market's response to where the economy is headed.

The most common portfolio for retirement savings is a 60/40 portfolio comprised of 60% in equities and 40% to fixed income. To suggest that type of passive portfolio has struggled in 2022 is the understatement of a century. Only 1932 had a worse first half of the year compared to 2022 and Treasuries have traded in almost unthinkable territory. The 10-year Treasury is on track for the worst first half since 1788 (not a typo). The flight to safety trade into Treasuries that provide diversification for investors has backfired and passive portfolios have been devastated.

We believe that financial conditions will get much tighter than they are today, with the Fed committed to rate hikes until the curve is solidly inverted, which would suggest that a recession is then present. Both consumer and business confidence, considered leading indicators, are declining after with the University of Michigan Consumer Sentiment at an all-time low. Announced layoffs are occurring at an alarming rate as companies attempt to "right-size" for what they expect business activity to be in the future.

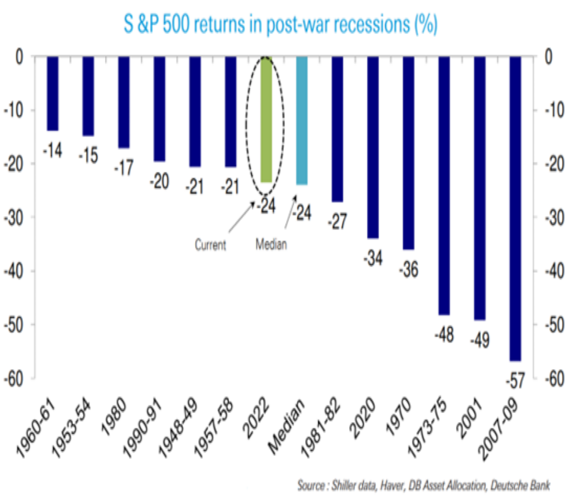
The S&P 500 was down 24% as of late June making it the 4th worst non-recession correction since WWII.

Given the dramatic drop in prices of stocks and bonds, the most commonly asked question today is, "are we near a bottom?" History would suggest we are; the five worst first half stock performances were all followed by strong second halves with average gains over 15% and all recovering over 10%. That seems overly optimistic today given that the Fed has announced its intention to keep its foot fully depressed on the brake to fight inflation.

Some are expecting fiscal policy, namely government stimulus plans, to rescue the economy but that seems highly unlikely in our view given the current political environment. If the special election for the House seat vacated by Rep Vela in Texas' 34th congressional district is any indication, there will be a Red Wave this mid-term. A seat held by Democrats for 150 years in a district every Democratic candidate for President has won for generations was flipped and won by a Republican by a wide margin. Republicans have publicly stated their belief that rising inflation is the result of reckless government spending during the pandemic.

So, what do you do when nothing is working? How do you diversify when the correlations of most assets are positive? First, understand your strategy for managing risk. If you are simply "hoping" for the markets to recover, you may be disappointed. While stocks are sharply lower, we remain a long way from the median valuation during a recession. Stocks could fall another 30% from current levels and still not be undervalued in a contracting economy. Second, realize that correlations often change rapidly benefitting tactical strategies. While stocks may be unlikely to recover in the second half of 2022, it is possible that long duration Treasury bonds post strong second half returns as those yields fall. Last, hold alternatives where returns are not dependent on the stock market or Fed policy. Private credit is a good example of a strategy that can generate reasonable returns in an uncorrelated manner.

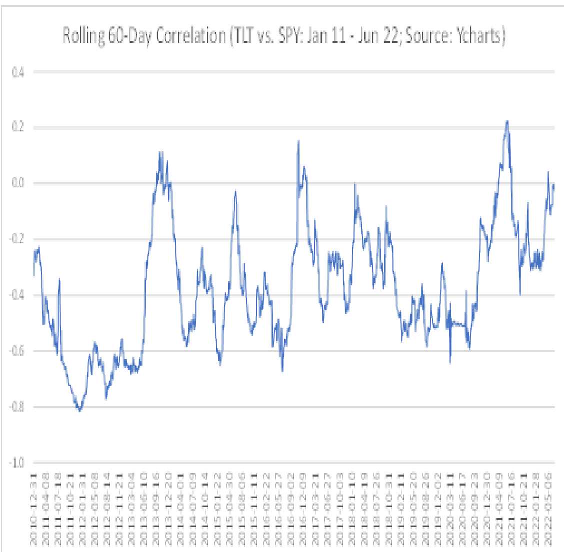
Recessions and Returns



The U.S. economy has recorded 13 recessions since the conclusion of WWII, including the very brief recession of 2020. The median drop in the S&P 500 for the recessions is 24%, the same drop the markets experienced in the first half of 2022 without any official declaration of a recession (officially triggered by two consecutive quarters of negative economic growth). Recessions are commonly measured by the drop in stock indices but are also measured by the length of the recession and the level of economic contraction. When attempting to forecast how far stocks will fall, it is helpful to try and determine how long the recession will last and how much contraction will occur. If the Fed follows through on their commitment to hike rates until inflation tames, the coming recession may prove to be much longer than normal.

- The average post-WWII recession has lasted 10 months and has been followed by an average of 57 months of economic expansion resulting in recessions during only 15% of the economic cycle.
- The Great Recession was the longest post-WWII recession lasting 18 months between December of 2007 and June 2009. The shortest was just six months from January to July 1980.
- Given the 24% fall in stock prices prior to the start of a recession and the potential for any coming recession to be lengthy due to Fed policy, it is possible to see stock returns similar to 2007-09.

Stock/Bond Correlations



If 2022 has taught investors anything it is that the correlation of returns between stocks and bonds is not always negative. One of the cornerstones of portfolio management is the notion that we can diversify risk by holding a mix of stocks and bonds. In theory, when equity market risk is elevated, investors will generally turn to the safety of bonds. Hence, the losses in equities can be somewhat offset by the gains in bonds. But this relationship does not always hold true. Today we are confronted with a hawkish Fed determined to quell inflation by raising interest rates, which has pushed the correlation of stock and bond returns positive.

- The chart to the left illustrates the rolling 60-day correlation between the iShares 20+ Year Treasury ETF (TLT) and the SPDR S&P ETF (SPY) going back to 2011. As we can see over the period, correlations have trended somewhat higher, albeit far from a smooth pattern.
- The implications of this trend are far reaching as our reliance on bonds to diversify equity risk becomes more suspect. Investors should consider alternative ways to diversify their portfolios, such as utilizing short positions or cash.

Tech Hiring Slowdown

With growing fears that the U.S. economy is headed towards a recession, many large tech employers have begun to announce layoffs, hiring freezes, and some have even reported rescinding job offers to candidates. Some of the most prominent companies announcing layoffs include Tesla and Coinbase. While Meta, Microsoft, and Uber announced that they will be slowing down hiring citing inflation and recession fears as a primary factor. This signals a drastic shift in sentiment from just a few years ago where there were ample employment opportunities and individuals were voluntarily resigning to switch employers. As more companies are impacted by a possible recession, they will face the difficult decision as to whether or not it is in the best interest of the company to lay off some of their workforce.

- Tesla CEO Elon Musk sent an email to employees earlier this month sharing plans to cut 10% of salaried workers, while Cryptocurrency exchange Coinbase shared this week that it was letting go almost a fifth of its workforce, or around 1,100 people.
- However, some are skeptical of the slowdown as U.S. employers posted 1.1 million tech jobs in Q1 2022, an increase of 43% from a year earlier.
- Coinbase CEO Brian Armstrong told his employees "Our employee costs are too high to effectively manage this uncertain market" and that the company “grew too quickly”.

Macro View – Yellen's Take on Inflation

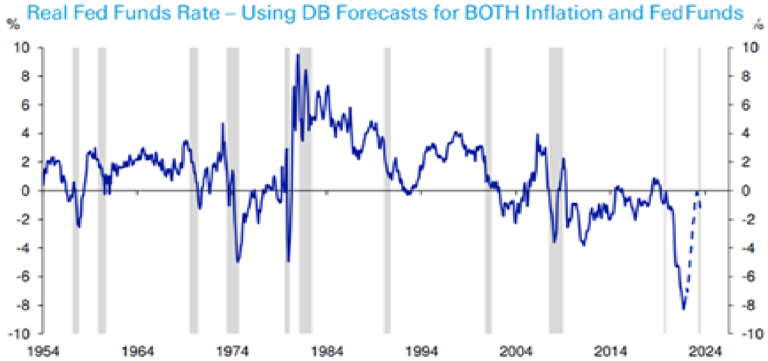
In an interview last month with ABC News' "This Week", Treasury Secretary Janet Yellen communicated that she "expects the economy to slow" but does not believe a recession is inevitable. However, talks of a recession have progressively increased, especially as of late when the Federal Reserve took an aggressive stance on combating inflation by raising the federal funds rate by 75 basis points, the largest increase since 1994. And while Ms. Yellen remains optimistic about the possibility of the U.S. avoiding a recession, she noted that current inflation numbers are "unacceptably high". With the next CPI data release on July 13, many will be watching to see if the Federal Reserve's recent actions were enough to move the needle on bringing down inflationary pressures.

Source: Reuters

Fixed Income – Faux Volcker

In the recent weeks, there has been discussions around whether Jerome Powell should act a bit more like Paul Volcker in order to combat inflation. Volcker, who was best remembered for taking an aggressive, yet painful stance on inflation, increased the short-term interest rate to almost 20% and sent unemployment north of 11%. However Deutsche Bank's view, as illustrated in the chart below, is that we will not have a Fed funds rate back to positive territory in real terms until 2024 (using headline year-on-year CPI as the adjustment). Until the real rate is positive, one could consider that fed policy is still very much accommodative. However, because the Fed failed to raise rates when many argued they should have, the Fed may end up overshooting their target and driving the economy into a brief recession in 2024, later than others are currently predicting.

Real Fed Funds Rate – Using DB Forecasts for BOTH Inflation and Fed Funds



Source : FRB, BLS, Deutsche Bank

Taking Stock – Bitcoin a Commodity?

As Bitcoin and other cryptocurrencies have gained popularity over the last few years, we have done our best to not only educate our audience, but also keep those of you updated with the ongoing changes in the space. Just recently, Securities and Exchange Commission Chairman Gary Gensler noted on CNBC's Squawk Box that while cryptocurrencies are a highly speculative asset class, Bitcoin was the only cryptocurrency he was ready to publicly label a commodity, rather than a security. With this classification, it would give the Commodity Futures Trading Commission (CFTC) a key role in the oversight of bitcoin markets instead of the SEC, who regulates the securities markets. Gensler argued that such oversight will be positive for the industry as it will bring "fairness, transparency and investor protection to markets for digital assets", something that many believe is long overdue.

Technical – Where is the bottom?

On June 13th, the 10 Year Treasury Yield hit a high of 3.4830%, a level not seen since 2011. Since reaching that level, the 10 Year has fallen 14.4% back to around 2.98% at the time of this writing. In last week's Eye on the Market from JPMorgan, Michael Cembalest provided the chart below where he notes that equity markets did not "bottom" until long term Treasury Yields were declining, or at least until they stopped rising. The vertical bars in the chart represent bottoms in the equity markets, and in the last three cycles, bond yields began to fall before equities bottomed. So, the biggest question we must ask ourselves is whether treasury yields have peaked. If they have, it could be a positive sign for investors to start entering back into the market, even as we continue to see deteriorating economic data.

Bond yields peak prior to equity market bottoms

Percent, 10 year Treasury yield

Source: Bloomberg, Shiller, FRED, JPMAM. June 23, 2022. Shaded bars indicate S&P 500 Index bottoms.

Inflation 101

Clint Pekrul, CFA

With all the inflation talk in the media these days, we don't want to casually assume our readers fully understand what inflation is and what it means for their finances. In this section of the PCM report we will delve into the inflation dilemma and reinforce why it is important for investors to appropriately position their portfolios.

Inflation

Google inflation and you will see it defined as "a general increase in the price of goods and services in an economy". A general rise in overall prices is not necessarily a bad thing - a moderate degree of inflation essentially forces capital into risk -taking endeavors.

While liquid, idle cash does not provide a compelling return, considering the erosion of purchasing power over time. The deleterious effects of inflation will force economic forces (i.e., the "invisible hand" of Adam Smith) to allocate capital to endeavors that produce returns above and beyond the rate of inflation.

In other words, the prosect the losing real purchasing power due to inflation compels people to undertake risk-seeking behavior that potentially delivers great wealth over time. This wealth generation is real – the rate of wealth accumulation for business owners and entrepreneurs generally far exceeds the rate of inflation.

Inflation's causes are multifaceted. In general, there are three primary causes of inflation that economists generally agree upon. First, a general rise in prices could be caused by a supply shortage like what we are facing today. For example, the underlying economy could be reasonably strong, but due to outside events (e.g., Ukraine, China COVID, etc.), supply cannot keep up with demand. The result (obviously) is product scarcity and higher prices overall.

The second cause of inflation is upward pressure on wages. Often the most meaningful expense for any business, a swelling payroll tends to force businesses to pass along the higher payroll expense to their end customers (i.e., higher prices). Interestingly, the global shut down due to COVID two years ago seems to have given labor somewhat of a leg up in terms of wage demands.

The third cause of inflation is due to monetary policy errors. Central banks such as the Federal Reserve control the supply of money in circulation through monetary policy. Raising interest rates is essentially curtailing the supply of money (i.e., dollars) in circulation. Money becomes scarcer and the cost to obtain it (i.e., interest) goes up. Conversely, if the Federal Reserve is "easy" we have an abundant supply of currency. Considering the limited supply of goods and services and the unlimited supply of fiat currency, we tend towards inflation.

The potential error is for the Federal Reserve to maintain an "easy" monetary policy for too long. Today, real interest rates are still negative across all maturities, despite the recent Federal Reserve policy hike. We started down this path years ago. Reversing course will not be easy.

A currency's devaluation (i.e., inflation) is essentially a tax on spending. Warren Buffet – the Oracle of Omaha – described inflation perfectly. It is akin to a tape worm that swindles everybody. Consider that an 8% year-over-year inflation rate implies that your dollar of savings a year ago is now only worth $0.92 today, if you make no investment.

What to Do?

Today it feels like the three forces of inflation are all working at once. On the one hand, we have supply chain bottlenecks that prevent inventories from flowing smoothly throughout the system, which in turn leads to empty shelves (i.e., scarcity) and higher prices.

On the other hand, we have a central bank that is dead set on curtailing demand through monetary policy by raising interest rates. The bank's actions will no doubt pop a few bubbles along the way. We have seen this is certain parts of the market, namely technology. Likewise, the once blazing hot housing market is showing signs of slowing as the thirty-year mortgage rate has hit a multi-decade high.

Likewise, the gig economy has to some degree empowered workers to bargain for higher wages. In many cases, employees are no longer required to work at the office, and can set their own hours working remotely. This trend could put upward pressure on wages, which companies will ultimately seek to pass along to the end consumer.

In an inflationary environment, it makes sense to allocate to investments that generate cash flows that at least keep pace with the rate of inflation. For example, consider stocks that provide reliable dividends that grow over time. These cash flows can partially offset the loss of purchasing power due to inflation.

Likewise, consider alternative investment strategies such as managed futures. These strategies can take advantage of trends in broad asset classes such as equities, bonds, currencies and commodities, and take both long and short positions. These strategies have done quite well in 2022 as commodity prices have soared and the dollar has strengthened.

What should not be an option is to sit on idle cash because it is almost certainly going to lose purchasing power. While we may no longer have an accommodative Fed, it is important for investors to stay the course and perhaps be a bit more defensive over the near term.

Q: How will this recession impact savings for retirement of Baby Boomers?

Sadly, this recession and the bear market that will accompany it could not come at a worse time for most Baby Boomers who are nearing retirement or just retired. Affluent Boomers are very likely retired years ago or at least were working only because they wanted to, not because they had to. The youngest half of Boomers and oldest of the Gen Xers are in that period of around five years to retirement where a prolonged bear market will do the greatest damage. A recent MarketWatch survey shows how dire the situation is for many approaching retirement. Respondents with a median age of 60 who are still working have an average retirement savings of just $112,000. Less than half have $100,000 saved and one-third are currently not making any contributions.

We are facing a recession that may be longer and more severe than what we experienced from 2007-2009. Because of the Fed's financial repression, keeping interest rates near zero for so long, recent retirees have been forced to accept far more risk in their portfolios to generate any income for retirement. These retirees are at risk of losing, or already lost, 30% or more of their savings, as they relied on appreciation from large cap tech and other growth sectors to fund their lifestyle. Many will have to rely on Social Security as their income is dramatically reduced.

If we indeed slip into a recession (some might argue that we are already in a recession), the ramifications this time around could be much different than the last recession of 2008 and the prior recession of 2001. What would differentiate a recession today from the prior two is the impact of inflation and negative real interest rates. Typically, as we grow older, we allocate more of our assets to the perceived security of fixed income investments which provide the interest income to fund our retirement years. While the Federal Reserve is raising interest rates to combat inflation, we are still a long way from having positive real yields. This means inflation is eating away at the savings of millions of Baby Boomers either at or approaching retirement.

The consequence of higher inflation is that retirees will likely have to dip into their savings to fund their golden years, rather than live off the interest income their savings provide. As retirement funds are depleted, retirees face a grim scenario of having insufficient means to support even the most basic lifestyle. Indeed, inflation is essentially a tax that eats away purchasing power. While there are cost of living adjustments made to pensions such as Social Security, the income provided from retirement savings will, in many cases, fall short of spending needs.

Q: How will we know when there is a bottom in the market?

There is an old saying on Wall Street that no one rings a bell at the top, or bottom of the market, and nothing could be truer. Sure, there is always a trader fortunate enough to buy or sell at the exact right time, but no one has ever demonstrated an ability to be right on a continual basis. In fact, buying stocks as they decline because they "look cheap" is typically referred to as catching a falling knife. When you attempt that, you often end up bleeding. It is possible to look at long-term average valuations at market bottoms, but there is no guarantee we get there or stop there.

Prudent investors with long-term investing horizons will begin to buy stocks when they are convinced valuations are compelling and not worry about whether or not the bottom is in. Do not make the mistake of thinking because a stock is down 50% it must be "on sale". Many stocks today are down 50% and are still wildly overpriced based on their fundamentals. History does suggest the stock market will likely bottom a month or two before the recession ends as traders start seeing positive forward guidance. We are early in the bear market, so it is likely patience will be an investing virtue in the coming months.

Unfortunately, my crystal ball isn't all that clear when it comes to timing market bottoms and tops. However, there are some indicators we can evaluate to gauge the likelihood that we are at or near a bottom. From a technical standpoint, we can always look for patterns that have historically coincided with market bottoms, such as comparing the current level of the S&P 500 Index to its 200-day moving average. If current valuations fall well below the long-term moving average, the market could be deemed "oversold" which in turn could signal a buying opportunity. However, technical analysis is fundamentally an exercise of looking in the rear-view mirror. Ultimately, historical patterns might not repeat going forward, which makes timing decisions difficult.

From a fundamental standpoint, we can look at metrics such as price to earnings to ascertain if the market is deeply "oversold" and trading at a cheap valuation. Likewise, we can look at the selling activity of the average retail investor, which tends to intensify as conditions worsen. Ultimately, there is no way to determine the market bottom except through hindsight. Rather than trying to time the bottom, a better approach might be to manage the volatility of returns over time by dialing up or down your overall exposure to the market.

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